CUPERTINO

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AUDIT COMMITTEE STAFF REPORT

Meeting: December 11, 2018

Subject

Review and provide recommendations regarding the City Investment Policy for the City's Public Agencies Post-Employment Benefits Section 115 Trust.

Recommended Action

Review and provide recommendations regarding the City Investment Policy for the City's Public Agencies Post-Employment Benefits Section 115 Trust.

Discussion

Summary

The City has elected to establish and fund a secondary pension trust (Section 115 Trust) to assist in stabilizing the potential impact of pension cost volatility on the City's operating budget. On May 15, 2018, City Council voted to adopt a Section 115 Trust and on June 5, 2018, City Council approved increasing the CalPERS Reserve to $8 million. On July 17, 2018, the Audit Committee approved the selection of Public Agency Retirement Services (PARS) as the third-party administrator of the City's Public Agencies Post-Employment Benefits Section 115 Trust.

The Audit Committee has been tasked with reviewing and approving the Section 115 Trust investment policy, which includes the asset allocation targets. Once the Section 115 Trust is established, U.S. Bank will invest assets in accordance with the investment policy.

Background

Section 115 Trust

A Section 115 Trust is a tax-exempt investment tool that allows local governments to pre-fund pension and retiree health costs. The City intends to use the Section 115 Trust for the following purposes:

- grow assets for future pension contributions;
- invest assets over appropriate time horizons;
- earn higher investment returns than the General Fund;
- reduce pension contribution volatility; and
- diversify funds from CalPERS investments.

Asset Allocation

Strategic asset allocation – the mix of asset classes including equities, fixed income, and cash – can help a portfolio reduce risk and earn more consistent returns over time. Diversifying across asset classes with low correlations to each other can help a fund to optimize risk-adjusted returns. Historical analysis of American pension plans has demonstrated that asset allocation explains over 90% of the variability in a fund's returns.[1] In short, asset allocation is the most important driver of a portfolio's volatility and an important driver of its long-term returns.[2]

To determine the fund's asset allocation, it is important to consider the City's time horizon, risk tolerance, and return objectives. Risk tolerance refers to the degree of volatility the City is able to withstand in exchange for higher potential returns. Investment time horizon refers to the expected length of time the City will invest the funds before withdrawing those funds.

The City intends to use the Section 115 Trust to pre-fund pension costs and proactively address the unfunded liability. The City's goal is to have sufficient assets in the Trust to increase the funded status to over 80% within 20 years, as well as fund the difference between a 7.0% and 6.25% discount rate. Each year, the City will analyze the most recent CalPERS actuarial valuations and evaluate opportunities to more efficiently address the City's unfunded pension liability including through contributions to the Trust, additional discretionary payments (ADPs) to CalPERS, or re-amortizing liabilities over shorter time horizons. Therefore, while contributions to the Trust will vary each year, the City intends to invest funds in the Section 115 Trust over a long time horizon and does not intend to withdraw funds in the first 5 years.

U.S. Bank portfolio managers have worked with the City to recommend an asset allocation and investment policy for the Section 115 Trust. Once the Section 115 Trust is established, U.S. Bank portfolio managers will manage security selection and tactical asset allocation in accordance with the investment policy.

U.S. Bank offers multiple asset allocation strategies including Conservative Income (10-30% equities), Income (35-55% equities), Balanced (50-70% equities), and Growth (60-80% equities). Each asset allocation strategy offers different risk-reward tradeoffs. The majority of public agencies have selected the Conservative Income strategy for their Section 115 Trust. However, given the current market outlook and the City's long time horizon, Rick Rosenthal, Portfolio Manager at U.S. Bank, has recommended a hybrid strategy. The hybrid strategy is designed to provide moderate income with moderate growth of capital. It is designed for investors with moderate tolerance for volatility and minor declines in investment value. The hybrid strategy would have the following asset allocation ranges and targets:

Asset Class	**Range**	**Benchmark Target**
Fixed Income	40-60%	50%
Equities	30-50%	41%
Real Estate	0-15%	5%
Commodities	0-10%	2%
Cash	0-10%	2%

The City agrees with Rick Rosenthal's recommendation. The City's analysis of the risks and opportunities in each asset class follows.

[1] Ibbotson, R., & Kaplan, P. (2000). Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance? Financial Analysts Journal, 56(1), 26-33.
[2] Xiong, J., Ibbotson, R., Idzorek, T., & Chen, P. (2010). The Equal Importance of Asset Allocation and Active Management. Financial Analysts Journal, 66(2), 22-30.

Fixed Income

Risks

Fixed income securities are subject to changes in interest rates (interest rate risk), changes in inflation rates (inflation risk), the ability of an issuer to make timely payments of principal and interest (credit risk), and the creditworthiness of the issuer and general market liquidity (market risk).

Interest rates are likely to move higher as the U.S. Federal Reserve reduces its balance sheet to prevent the economy from overheating amid rising inflation and decreasing unemployment. After nearly a decade of zero to negative short-term interest rates and central banks expanding their balance sheets, the trend is now toward tighter monetary policy. The Federal Reserve raised rates during its June and September policy meetings and signaled that it continues to view gradual interest rate increases as appropriate provided the economy evolves in line with its expectations. Outside of the U.S., the Bank of England, Bank of Canada, and the Reserve Bank of Australia look likely to tighten monetary policy in 2019.

When interest rates rise, the market price of bonds falls. As a result, it is important to consider interest rate risk when purchasing bonds in a low-interest rate environment. A sustained period of rising yields would act as a headwind to bond returns.

Opportunities

Although fixed income has lower expected returns compared to equities, fixed income can help a portfolio reduce volatility and generate income. Given its low volatility and low correlation with equities, fixed income is an important part of a balanced portfolio.

Equities

Risks

Equity investments are subject to market risk, which is the possibility that the market value of securities in the portfolio will decline.

The end of 2018 has served as a reminder of the volatility in equity markets. In the outlook for 2019, there are significant risks including protectionism, trade tensions between the U.S. and China, China's economic slowdown, rising populist sentiment in Europe, geopolitical tensions in the Middle East, and tightening financial conditions.

Multiple indicators suggest that the U.S. is at a late stage in the business cycle. Credit spreads are narrow and delinquency rates on auto and credit card loans are beginning to rise, both of which are consistent with late-cycle behavior. With short-term interest rates increasing at a faster pace than long-term yields, the slope of the yield curve has flattened and indicates that the business cycle is in its later stages. But the yield curve has not yet inverted, which has historically been a strong indicator of imminent recession. Although the business cycle shows few signs of ending, equities are likely to face increased volatility amid rising interest rates and trade uncertainty. Furthermore, growth is likely to slow in 2019 as financial conditions tighten, interest rates rise, and the fiscal stimulus from the U.S. Tax Cuts and Jobs Act (TCJA) begins to fade.

Opportunities

Historically, equities exhibit high volatility but have performed well compared to inflation over longer time horizons.[3] Despite their high volatility, historical data suggests that equities are an important part of any

[3] Boudoukh, J., & Richardson, M. (1993). Stock Returns and Inflation: A Long-Horizon Perspective. The American Economic Review, 83(5), 1346-1355.

asset allocation aimed at achieving total positive returns.[4] This is because, historically, stocks have outperformed fixed income and cash on a risk-adjusted basis.

Although global GDP growth is expected to slow in 2019, economic fundamentals should continue to support earnings growth in equity markets, especially in the U.S. There is sufficient economic strength and earnings momentum in the U.S. to drive equity returns, particularly in the short to medium term. However, given the late stage in the business cycle, high equity valuations, and upward pressure on inflation, earnings growth rather than multiple expansion is expected to be the main impetus of equity returns.

Cash and Cash Equivalents
Risks
Cash and cash equivalents are subject to inflation risk, which is the possibility that inflation will outpace and erode investment returns over time.

Opportunities
Cash and cash equivalents have the lowest volatility, but also the lowest return of the asset classes. Cash helps provide liquidity and lower the volatility of a portfolio. Historically, cash has performed well during periods of rising interest rates and stock market volatility due to its short duration and low volatility.

Recommendation
Considering the City's time horizon, risk tolerance, and return objectives, as well as the risks and opportunities of each asset class, the City recommends a hybrid (41% equities) asset allocation.

Given the current market volatility, the City also recommends that the funds be invested using a systematic implementation plan – also known as dollar-cost averaging – over one year as a risk-reduction strategy.

Sustainability Impact
No sustainability impact.

Fiscal Impact
No direct fiscal impact at this time.

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Approved for Submission by: Amy Chan, Interim City Manager
Attachments:
A – City of Cupertino Pension Trust Policy

[4] Siegel J. (1998). Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies.